AMI INVESTMENT MANAGEMENT
Registered Investment Advisor

Notes from the Road

Midwest Wanderings **September 2013**

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We hope that you had a wonderful end to the summer and like us are looking forward to the beauties of fall, including cooler weather, football and chili. Weôve been busy ñhitting the road,ò using our on the ground research to try to locate interesting investment opportunities.

Back on the Farm

In our last *Notes from the Road*, we chronicled a day-long trip to a large farming operation in northeast Indiana and highlighted our concern that the industry may face some struggles over the near-term. Longing to get back in the fields, we spent another day touring farming operations in Noble County and speaking with farm operators (much thanks to Rick Sherck at the Noble County EDC for the opportunity). Our research solidified our concerns ï a number of farmers shared with us that they have taken advantage of high incomes the past few years, driven by strong domestic crop yields and high commodity prices, to improve their capital stock (i.e. their supply of tractors and machinery). In other words, the average age of farming equipment looks to be quite low. Accordingly, if commodity prices continue to exhibit weakness (corn is down some 30% from late last year), farmers may drastically cut back on capital expenditures, pressuring companies that depend on such demand. Prices of farmland, which have been on a tear the last few years, may also face pressure. We will keep a close eye on the industry, as it holds the potential to be a field ripe for our kind of investment ï it is understandable, necessary and may be mispriced at some point in the near future. But we will remain quite conservative for the time being.

Jacob checks out a brand new New Holland harvester recently purchased by a local farmer.

David surveys new equipment at a local fruit farming operation.

Stock Scuttlebutt

The investor Phil Fisher introduced the term ñscuttlebuttò to describe the intensive research process that should accompany stock investments. Reading public filings and research reports is just a starting point. In order to truly understand a company, it is necessary to get out in the field and talk to people involved in the business ï management, employees, competitors, suppliers, customers, etc. This is not an easy task, as it can be hard to make the connections needed to get good information. But we believe it is the best way to drive the kind of informational advantage needed to make smart stock purchases.

As an example, we recently had the chance to visit the headquarters of one of our portfolio holdings. The company makes important components that go into large trucks (dump trucks, buses, semi-trailers, etc.). During our visit, we met with management, toured one of the companyôs manufacturing plants and even got to test drive several heavy-duty trucks! During the test drive, we had the opportunity to compare the performance of trucks equipped with our companyôs products versus those equipped with competitorsô products. Perhaps the best part of the day, however, was when David was able to spend fifteen minutes one-one-one with the former head of engineering peppering him with questions. Information from such divisional employees is often invaluable, as comments arenôt as scripted as those from top management. We came away comfortable with the company and its management team while also focused on potential competitive threats that could emerge over the next 5-10 years.

(Left) David on the open road behind the wheel of a big-rig – now this is what we call stock research! (Right) Jacob on the manufacturing floor of our portfolio company. Even though he's a finance guy, his Dad has spent his career running manufacturing operations, so he at least knew how to avoid looking completely out of place!

Cleveland, OH

Earlier in the summer, we had a chance to meet with two different private equity firms headquartered in Cleveland, Ohio. A private equity fund, as the name implies, invests in private companies. The industry received a lot of press during the last presidential election (Republican candidate Mitt Romney started Bain Capital, a successful private equity firm). Many funds are referred to as ñleveraged-buyout fundsò (LBO) because they have a tendency to utilize a lot of borrowed money in an effort to juice investment returns.

While AMI has never had a huge investment in the space, weôve had a consistent presence since our founding in 1995. (Of course we only invest in private investments if a client has specifically given us that authority and almost all funds have steep minimums, greatly limiting potential qualifying investors.) Weôve found that in rare cases when we can find a partner that we truly trust who has operational expertise in a specific industry, the results can be compelling.

Cleveland or bust!

However, the field has become incredibly crowded and competitive. The biggest upside to private equity is that investors typically find a better alignment of interests between themselves and the management team relative to the situation found in public companies. Public management teams often enrich themselves at the expense of shareholders. Private equity management teams are compensated directly according to how much cash they return to shareholders, giving them stronger incentives to maximize returns and hold down expenses.

But this advantage is offset by several notable disadvantages. First, expenses in the industry are very high. Outsized expenses were tolerable when potential excess returns were strong. In todayôs competitive market, it is harder to justify these fees. While there has been some downward pressure on expenses, it hasnôt been enough to compensate for increased competition. One private equity manager that we met with, an acquaintance who manages money for large endowments and wasnôt currently raising any money (resulting in a refreshing level of candor), confessed that his firmôs return bogeys have come way down from the levels they targeted 15-20 years ago. Second, private equity is an illiquid, winner-take-all market. Public stocks trade in an open-bid market, meaning that prices are quoted every minute of every trading day. During certain periods, when sellers drastically outnumber buyers, prices can fall precipitously, giving the disciplined value investor the opportunity to purchase minority interests in great businesses at fire-sale prices. Private equity investments, however, are discrete, all-or-nothing affairs. While a number of factors go into successfully buying a private company, the most important factor by far is price. This winner-take-all market suffers from the ñwinnerôs curseò ï the guy willing to pay the highest amount for the business is the one who has overvalued it. The environment is tougher now than it was ten years ago, as money has flooded the private equity market and a number of professional, ambitious small- to middle-market investment bankers have emerged to help sellers extract the highest prices they can.

On top of this, investors have to account for the high amounts of leverage placed on investments. Indeed, David Swensen, Chief Investment Officer for Yale University, points out that public stocks, contrary to accepted wisdom, have actually done much better than private equity on an apples-to-apples basis, i.e. once the high levels of debt seen in private equity are taken properly accounted for. Lots of leverage and high levels of illiquidity should force investors to demand superior prospective investment returns before making any large commitments.

This isnôt to say that we wonôt invest in private equity going forward. We still have several historical relationships with strong, operational-oriented managers that we believe can post strong investment returns. Itôs a more competitive market, but there are still potential inefficiencies to exploit assuming a manager is well-aligned with his investors, knows his end markets in and out, and doesnôt try to raise a huge amount of capital (the market for large private businesses is simply too efficient). Unfortunately, such managers turn out to be a rare occurrence.

Sincerely,

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